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Jack Doherty, Richmond District

Phyllis E. Marcus, Chief, Branch 2, Office of the Associate Chief Counsel (International) CC:INTL:2

[redacted]

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This memorandum is in response to your request for additional assistance about issues raised under section 956 of the Internal Revenue Code with respect to [redacted]. Specifically, you requested our response to issues the taxpayer raised in its memorandum of January 25, 1991 and in an informal taxpayer conference on April 11, 1991.

FACTS:

On [redacted], a domestic corporation, purchased all of the stock of [redacted], a U.K. corporation. [redacted] made a section 338 election with respect to this purchase and selected [redacted] as the deemed acquisition date for purposes of this election. At the time of this acquisition, [redacted] owned all of the stock of [redacted], a U.K. corporation, which owned all of the stock of [redacted], a domestic corporation.

When [redacted] acquired the stock in [redacted], [redacted] held two obligations of [redacted] on which the total outstanding balance was $[redacted]. The first obligation was acquired on [redacted], when [redacted] lent [redacted] the principal amount of $[redacted]. The second obligation was acquired on [redacted], when [redacted], a wholly-owned subsidiary of [redacted] lent [redacted] the principal amount of $[redacted]. [redacted] transferred this receivable to [redacted] on [redacted] in satisfaction of other

obligations due [redacted] by [redacted].

ISSUES:

(1) Do loans that [redacted] or its wholly-owned foreign subsidiary made to [redacted]'s second-tier domestic subsidiary, [redacted], before [redacted] became a controlled foreign corporation (CFC) constitute "United States property" within the meaning of section 956(b) of the Code?

(2) If these loans are United States property under section 956(b), does Rev. Rul. 74-436 provides a proper method for computing [redacted]'s increase in earnings invested in United States property?

LAW & ANALYSIS:

I. Pre-existing loan

Section 956(b)(1) of the Code lists general categories of property that are "United States property" for purposes of section 956. Section 956(b)(1)(C) defines U.S.property to include "an obligation of a United States person." Section 1.956-2(a)(1)(iii) of the Income Tax Regulations provides that United States property is (except as provided in section 1.956-2(b)) any property acquired (within the meaning of section 1.956-2(d)(1)) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any taxable year of the foreign corporation beginning after December 31, 1962, which is an obligation of a U.S. person. Section 1.956-2(d)(1) of the regulations provides that property shall be considered acquired by a foreign corporation when the corporation acquires an adjusted basis in the property.

Section 956(b)(2) of the Code and section 1.956-2(b) of the regulations exclude certain property from the general categories of United States property provided in section 956(b)(1) and section 1.956-2(a) of the regulations. Section 956(b)(2)(F) excludes from the definition of United States property, the stock or obligations of a domestic corporation which is neither a U.S. shareholder of the CFC, nor a domestic corporation, 25% or more of the total combined voting power of which, immediately after the acquisition of any stock in such domestic corporation by the CFC, is owned, or considered as being owned by such U.S. shareholders in the aggregate.

Section 1.956-2(b)(1)(viii) of the regulations, provides that for purposes of determining whether the section 956(b)(2)(F) exclusion applies, the determination of whether a domestic corporation is an unrelated corporation

is made immediately after each acquisition of stock or obligations by the controlled foreign corporation.

[redacted] owned sufficient stock in [redacted] for purposes of the relatedness test of section 956(b)(2)(F), both before and after it became a CFC. However, the test for relatedness is measured by the stock ownership of the U.S. shareholder. [redacted] and [redacted] were not CFCs at the time they acquired the obligations of [redacted]. Accordingly, there is ambiguity about when to test for relatedness under section 1.956-2(b)(1)(viii) of the regulations.

The legislative history of section 956(b)(2)(F) does not specifically resolve this issue. Congress enacted section 956 because it believed that the "use of untaxed earnings of a controlled foreign corporation to invest in U.S. property was 'substantially the equivalent of a dividend' being paid to the U.S. shareholders." Report of the Committee on Finance, S. Rep. No. 94-938, 94th Cong., 2d Sess. 225 (1976). Congress became concerned, however, that a broad definition of U.S. stock or obligations would have a detrimental effect on the U.S. balance of payments by discouraging foreign corporations from investing in the United States. S. Rep. No. 94-938 at 226. To address these competing interests, Congress limited the scope of the term "U.S. property" by enacting section 956(b)(2)(F), so that an investment in U.S. property does not result when a CFC invests in the stock or obligations of an unrelated U.S. person. S. Rep. No. 94-938 at 226. The legislative history of section 956(b)(2)(F) provides that the test for relatedness "is to be applied immediately after the investment by the controlled foreign corporation." (Emphasis supplied.) S. Rep. No. 94-938 at 226.

Although the test for relatedness under section 956(b)(2)(F) measures the amount of stock owned by the U.S. shareholder, Congress nevertheless was concerned about the relationship between the foreign investor and the U.S person whose obligation it held. The legislative history of section 956(b)(2)(F) noted that prior law was overly broad because "the acquisition by the foreign corporation of stock of a domestic corporation or obligations of a U.S. person (even though unrelated to the investor) is considered an investment in U.S. property for purposes of imposing a tax on the untaxed earnings to the investor's U.S. shareholders." (Emphasis supplied.) S. Rep. No. 94-938. This legislative history does not indicate that Congress intended to protect investments by foreign corporations in their wholly-owned domestic subsidiaries.

Our position is that if a foreign corporation acquires an obligation before it becomes a CFC, if the obligation

otherwise qualifies as the obligation of a U.S. person under section 956(b)(1)(C) of the Code and section 1.956-2(a)(1)(iii) of the regulations, the test for relatedness under section 1.956-2(b)(1)(viii) of the regulations should be applied when the corporation becomes a CFC. If the obligation then satisfies the relatedness test it would not be excluded from the definition of U.S. property under section 1.956-2(b) of the regulations. Section 1.956-2(a)(1) of the regulations provides that property that is not excluded under section 1.956-2(b) of the regulations will be considered U.S. property, if it fits within one of the categories enumerated in that section, even if the property was acquired before the foreign corporation became a CFC. See also section 1.956-2(a)(2), ex. 3 of the regulations.

The obligations of [redacted] would satisfy the test for relatedness under section 1.956-2(b)(1)(viii) of the regulations if the test were applied when [redacted] became a CFC. The obligations of [redacted] would then qualify as U.S. property under section 1.956-2(a) of the regulations although they were acquired before [redacted] became a CFC.

We recognize that section 956(b)(2)(F), and the regulations thereunder, could be interpreted more narrowly to exclude the obligations at issue from the definition of U.S. property and therefore do not recommend litigating this issue.

II. Computation under Rev. Rul.74-436

Rev. Rul. 74-436, 1974-2 C.B 214 which was amplified by Rev. Rul. 82-17, 1982-2 C.B. 159, contains a chart that reflects the Service's current position on how to compute a corporation's increase in earnings invested in U.S. property for purposes of sections 956 and 951(a)(1)(B) of the Code. While this chart produces a fair result in most cases, it does not do so in cases like the one at issue, where earnings of the CFC fluctuate and its investment in U.S. property remains constant. In those cases, the amount computed as the corporation's increase in earnings invested in U.S. property may greatly exceed the corporation's investment in U.S. property.

Until we have corrected the problems in Rev. Rul. 74-436, which will require a regulatory and statutory change, we would like this revenue ruling to remain effective for those cases in which it now produces the correct result. We therefore do not think the validity of this revenue ruling should be litigated.

In cases like the one at issue where earnings fluctuate

and the aggregate investment is U.S. property remains relatively constant we believe that Rev. Rul. 74-436 should be interpreted to limit the section 956 increase in earnings invested in U.S. property to an amount no greater than the CFC's aggregate investment in U.S. property during the years at issue. In this case, when [redacted] acquired [redacted] s aggregate investment in U.S. property was $[redacted]. Its aggregate investment in U.S. property never exceeded this amount during the years at issue.

CONCLUSION:

The loans from [redacted] and [redacted] to [redacted] s wholly-owned domestic subsidiary, which were made before [redacted] became a CFC, should be treated as U.S. property under section 956. The amount determined to be [redacted] s increase in earning invested in U.S. property under Rev. Rul. 74-436 should not exceed the amount of [redacted] s aggregate investment in U.S. property ($[redacted]). Both the interpretation of section 956(b)(2)(F) and the validity of Rev. Rul. 74-436 are not clear issues and therefore we do not think this is an appropriate case for litigation.

cc: Judy Miller
Allan Bernstein